Filed 11/29/05 Ackerman v. Franchise Tax Bd. CA2/7

**NOT TO BE PUBLISHED IN THE OFFICIAL REPORTS**



IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION SEVEN

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| PETER ACKERMAN,<br><br>Plaintiff and Appellant,<br><br>v.<br><br>FRANCHISE TAX BOARD,<br><br>Defendant and Respondent. | B178750<br><br>(Los Angeles County<br>Super. Ct. No. BC 296334) |

APPEAL from a judgment of the Superior Court of Los Angeles County. Richard L. Fruin, Judge. Affirmed.

O'Melveny & Myers, Martin Glenn, Karen R. Growdon, Christopher W. Campbell for Plaintiff and Appellant.

Bill Lockyer, Attorney General, W. Dean Freeman, Anthony Sgherzi and Brian D. Wesley, Deputy Attorneys General, for Plaintiff and Respondent.

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Plaintiff Peter Ackerman (Ackerman) appeals a judgment of the trial court denying his request for a refund of taxes paid on California income that was subsequently returned to its source. Ackerman, who was no longer a California resident at the time the income was returned, argued that Internal Revenue Code (IRC) section 1341 (26 U.S.C. § 1341) had been incorporated into California law in 1983 and provided him the option of taking a deduction or a refund of taxes paid in the year of repayment. Finding that legal position in error, we affirm.

## FACTUAL BACKGROUND AND PROCEDURAL HISTORY

This dispute centers on whether IRC section 1341[1] has been incorporated into California law so that Ackerman may claim a refund of the tax overpayment rather than a deduction.

Ackerman currently is a resident of Washington, D.C. From 1986 through 1989, he resided in California; during the period 1986 through 1991, Ackerman received income and capital gains from investments in partnerships. Ackerman reported the income from these partnerships on his state tax returns (years 1986 through 1989) and federal tax returns (years 1986 through 1991), and paid taxes thereon.

In 1987, Ackerman was sued by numerous parties for allegedly wrongfully misappropriating and diverting investments from the partnerships. In 1992, Ackerman settled these lawsuits, and as a term of the settlement Ackerman returned income and gains for the years 1986 through 1991 to the partnerships. In 1992, he returned $55,999,997 of income and gains, and in 1993 he returned $17,000,000 of income and gains. The amount of the settlement attributable to Ackerman's California income for the period 1986 through 1989 is $59,825,780.40.

In December 1992, Ackerman entered into an agreement with the Internal Revenue Service which permitted to him to recover the taxes paid on the returned income through deductions taken in 1992 and future years. By that time, Ackerman no longer resided in California; he filed a non-resident/part-year resident California income tax return listing adjusted gross income of zero. In October 1996, the Franchise Tax Board (FTB) refunded Ackerman's 1992 withheld taxes in the sum of $7,354 plus interest. Ackerman's 1993 non-resident/part-year resident California income tax return listed adjusted gross income of $79,835; after a series of refunds and corrections, he paid $6,601 in income tax for the year.

Ackerman did not receive a refund of his California tax payments for the years 1986 through 1989 attributable to the settlement payments, nor did he take a deduction on his California return for the years 1992 and 1993 for the returned income. On April 15, 1997, he filed a California non-resident/part-year resident income tax form requesting refunds for the 1992 and 1993 tax years for taxes paid on the returned income. The FTB took no action on these requests for refund, other than to issue in June 1997 a "Return Information Notice" and other documents requesting payment of taxes.

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[1] IRC Section 1341 is a partial codification of a common law doctrine known as the "claim of right" doctrine. The claim of right doctrine permitted a deduction against income in the year of repayment of income reported in a prior year. IRC 1341 added to that right the opportunity to take a tax credit against tax due in the year of repayment. Section 1341 provides in relevant part at subsection (a) that if income declared under a claim of right in a prior year is returned to the source, "then the tax imposed by this chapter for the taxable year [of repayment] shall be the lesser of the following: [¶] (4) the tax for the taxable year computed with such deduction; or [¶] (5) an amount equal to-- [¶] (A) the tax for the taxable year computed without such deduction, minus [¶] (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years)."

On November 5, 2003, Ackerman filed this action for a refund of taxes paid on the returned 1986 through 1991 partnership income, seeking a return of $3,768,643.82 plus interest for 1992 and $1,143,393.41 plus interest for 1993.

At trial, Ackerman argued that he was entitled to a refund of the overpayment in taxes resulting from the adjustment to his income for the years 1986-1989. Asserting that a deduction was valueless to him because in 1992 and 1993, he had minimal reportable California income, he argued that limiting him to a deduction would result in a windfall to the state. Ackerman contended that IRC section 1341 had been incorporated into California law in 1983 through the Conformity Act (AB 36, Stats. 1983, Ch. 488) and by reference through Revenue and Taxation Code section 17076. Ackerman also argued that failure to grant a refund violated the Privileges and Immunities Clause because it discriminated on the basis of residence.

The FTB argued that the "claim of right" doctrine, which allowed the taxpayer a deduction in the year of repayment, was the only remedy for overpayment applied in California, citing *North Am. Oil Consolidated v. Burnet* (1932) 286 U.S. 417 and a 1976 State Board of Equalization decision, *Appeal of Vertullo* (July 26, 1976) California Tax Reporter (CCH) ¶ 205-505 [1971-1978 Transfer Binder] (section 1341 could not be applied because it had no analog in California tax law). Finally, the FTB asserted that Revenue and Taxation Code section 17076 only referred to a "deduction," not a credit, and that Revenue & Taxation Code section 17024.5 prohibited application of federal tax credits on a California return.

In July 2004, the court heard the case, took the matter under submission, and issued a Statement of Decision. Ruling against Ackerman, the court found that prior to 1983, California had no statutory counterpart to IRC section 1341, citing *Appeal of Lovering* (Apr. 21, 1966) California Tax Reporter (CCH) ¶ 203-271 [1962-1966, Part I Transfer Binder] ("there is no section in the California statutes which corresponds to section 1341"). And, after the 1983 legislation, *Appeal of Agnew* (April 6, 1989) California Tax Reporter (CCH) ¶ 401-722 [1986-1990 Transfer Binder] reinforced the principle that only the claim of right doctrine applied in California. At most, the trial court found California had adopted IRC 1341 for purposes of allowing a deduction only.

The court concluded that there was nothing in the record or California law to establish that IRC section 1341 had been categorically adopted into California law; moreover, Revenue and Taxation Code section 17024.5 specifically and unambiguously disallowed federal tax credits. The court noted the then pending legislation seeking to add section 17049 to the Revenue and Taxation Code to clarify confusion "regarding the claim of right deduction," demonstrated that IRC 1341 had not been incorporated as Ackerman alleged.

The court also rejected Ackerman's Privileges and Immunities Clause arguments on the grounds that there was nothing in the statutory scheme that was discriminatory on its face against non-residents. Furthermore, "an occasional or accidental inequality due to circumstances personal to the taxpayer will not invalidate a nondiscriminatory general rule," citing *Davis v. Franchise Tax Board* (1977) 71 Cal.App.3d 998, 1004.)

**DISCUSSION**

## I. STANDARD OF REVIEW AND RULES OF STATUTORY CONSTRUCTION.

We review matters of statutory construction as questions of law. (*Carver v. Chevron U.S.A., Inc.* (2002) 97 Cal.App.4th 132, 142; *Baker-Hoey v. Lockheed Martin Corp.* (2003) 111 Cal.App.4th 592, 596; see also *Smith v. Rae-Venter Law Group* (2002) 29 Cal.4th 345, 357 [independent review appropriate where issue involves the proper interpretation of a statute and its application to undisputed facts].)

The objective of statutory interpretation is to ascertain and effectuate legislative intent. The first step in determining that intent is to scrutinize the actual words of the statute, giving them a plain and common sense meaning. (*Hughes v. Board of Architectural Examiners* (1998) 17 Cal.4th 763, 775.) If there is no ambiguity in the statutory language, a court must presume that the Legislature meant what it said, and the plain meaning of the statute governs. (*Lennane v. Franchise Tax Bd.* (1994) 9 Cal.4th 263, 268.)

Only when the statutory language is ambiguous and susceptible to more than one reasonable interpretation do "we look to a variety of extrinsic aids, including the ostensible objects to be achieved, the evils to be remedied, the legislative history, public policy, contemporaneous administrative construction, and the statutory scheme of which the statute is a part. [Citations.]" (*Nolan v. City of Anaheim* (2004) 33 Cal.4th 335, 340.) "[A] subsequent expression of the Legislature as to the intent of [a] prior statute, although not binding on the court, may properly be used in determining the effect of a prior act." (*California Emp. etc. Com v. Payne* (1947) 31 Cal.2d 210, 213-214.)

Furthermore, we must select a construction that comports most closely with the apparent intent of the Legislature, with a view to promoting rather than defeating the general purpose of the statute, and avoid an interpretation that would lead to absurd consequences. (*Torres v. Parkhouse Tire Service, Inc.* (2001) 26 Cal.4th 995, 1003.) "And, wherever possible, 'we will interpret a statute as consistent with applicable constitutional provisions, seeking to harmonize Constitution and statute.' [Citation.]" (*People v. Superior Court* (*Zamudio*) (2000) 23 Cal.4th 183, 193.)

## II. SECTION 1341 WAS NOT INCORPORATED INTO CALIFORNIA LAW IN 1983.

### A. IRC Section 1341 and the Claim of Right Doctrine.

IRC Section 1341 provides that "(a)... If— [¶] (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;[¶] . . . [¶] . . . then the tax imposed by this chapter for the taxable year shall be the lesser of the following: [¶] (4) the tax for the taxable year computed with such deduction; or [¶] (5) an amount equal to -- [¶] (A) the tax for the taxable year computed without such deduction, minus [¶] (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years)." IRC Section 1341, subdivision (b)(1) provides that if the decrease in tax under section 1341, subdivision (a)(5)(B) is in excess of the tax imposed for the taxable year, the excess "shall be refunded or credited in the same manner as if it were an overpayment for such taxable year."

IRC section 1341 was enacted in 1954 to redress the inequities resulting from application of the common law claim of right doctrine. (*U. S. v. Skelly Oil Co.* (1969) 394 U.S. 678, 681-682 (*Skelly Oil*).) Prior to section 1341, under the claim of right doctrine, the taxpayer was limited to a deduction in the year the income was returned to its source. (*North Am. Oil Consolidated v. Burnet* (1932) 286 U.S. 417, 424.) As explained in *North American Oil,* if a taxpayer received earnings under a claim of right and without restriction as to its disposition but it later appeared that the taxpayer was not entitled to keep the money, the taxpayer was entitled to a deduction in the year of repayment. (*Id.* at p. 424.) "This approach was dictated by Congress' adoption of an annual accounting system as an integral part of the tax code." (*Skelly Oil, supra,* at p. 681.)

However, the rule resulted in inequities. In *U.S. v. Lewis* (1951) 340 U.S. 590, the taxpayer sought a refund of taxes paid on 1944 income that was returned in 1946. (*Ibid.*) *Lewis* rejected the taxpayer's claim for refund. "Income taxes must be paid on income received (or accrued) during an annual accounting period. . . . The 'claim of right' interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. . . . We see no reason why the court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to the taxpayer." (*Id.* at p. 592.) The dissent in *Lewis* criticized the majority, noting that "[m]any inequities are inherent in the income tax. . . . If the refund were allowed the integrity of the taxable year would not be violated. The tax would be paid when due; but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer." (*Id.* at p. 592, Douglas, J., dissenting.)

Furthermore, discrepancies resulted from the deduction system because the tax benefit from the deduction in the year of repayment might differ from the increases in taxes resulting from the returned income, or the taxpayer might be in a different tax bracket. Because of these problems and the *Lewis* decision, Congress enacted IRC section 1341. (See *Kappel v. U.S.* (W.D. Pa. 1968) 281 F.Supp. 426, 431; *Pike v. C.I.R.* (1965) 44 T.C. 787, 800.) Section 1341 provided two options to the taxpayer in the case of returned income: (1) the claim of right deduction (IRC, § 1341, subd. (a)(4)), or (2) a reduction in the amount of taxes for the current year by the amount taxes were increased in the year of receipt of the disputed income (IRC, § 1341, subd. (a)(5)). (See *Skelly Oil, supra,* at pp. 681-682.) "Nevertheless, it is clear that Congress did not intend to tamper with the underlying claim-of-right doctrine; [section 1341] only provided an alternative for certain cases in which the new approach favored the taxpayer. When the new approach was not advantageous to the taxpayer, the old law was to apply under section 1341(a)(4)." (*Id.* at p. 682.)

### B. California's 1983 Conformity Statute Did Not Incorporate Section 1341.

In 1983, California enacted legislation to bring its tax laws into conformity with federal tax law. (Stat. 1983, c. 488, § 2, eff. July 28, 1983.) The legislative history indicates California had historically adopted a selective approach to conformity with federal tax law. Although "automatic" conformity was compelling, serious doubts concerning its desirability persisted, most notable of which was the fact such conformity would require California to surrender its tax policy to the federal government. The 1983 conformity legislation provided that "State tax law is now referenced to the Federal Internal Revenue Code, with only the differences between the two spelled out in our law." (Assem. Rev. & Tax. Comm., Federal Conformity in the Personal Income Tax, Report on AB 36 and SB 813 (1982-1983 Sess., pp. 1-3.) Thus, in those areas in which state and federal law were to be in substantial conformity, the IRC was incorporated by reference into the Personal Income Tax Law, and where the state and federal law were not to be in conformity, the state differences were separately set forth. (See Rev. & Tax. Code, § 17024.5.)

The versions of Revenue and Taxation Code section 17024.5 in effect in 1992 and 1993, with minor language differences, essentially provided that unless otherwise specifically provided, any provision of the IRC applied which was operative on or after the specified date for that taxable year. (Rev. & Tax. Code, §17024.5, subd. (a)(4)(A) (1992 version), § 17024.5, subd. (a)(4)(A) (1993 version).) Exceptions were specifically enumerated. (See, e.g., Rev. & Tax. Code, § 17024.5, subd. (b)(1), et seq. (1993 version).) One of those exceptions is section 17024.5, subd. (b)(10), which excludes from the scope of incorporation "federal tax credits."

Although the Internal Revenue Code contains many forms of tax credits, it does not contain a general definition. (Maule, 506-2nd T.M. (2002) *Tax Credits: Concepts and Calculation,* p A-

10 (Maule).) "Implicitly, a credit is any amount that is allowable as a subtraction from tax liability for the purpose of computing the tax due or refund due." (*Ibid.*) A tax credit results in a "dollar for dollar" direct reduction in an individual's total tax liability, and a tax credit is "treated as a payment already made" against the individual taxpayer's tax liability. A tax credit is distinguishable from a tax deduction, which reduces the amount of income subject to taxation but does not directly reduce the individual's overall tax liability. (Maule, *supra,* at pp. A-7, A-11 (Maule).) A tax credit is considerably more significant to the taxpayer "because it is subtracted after tax is computed rather than before." (Thieman, *The Past, The Present, And The Future Of Pro Bono: Pro Bono As A Tax Incentive For Lawyers, Not A Tax On The Practice Of Law* (2005) 26 Hamline J. Pub. L. & Pol. 331, 371 (Thieman).)

Tax credits are either refundable or non-refundable. (Maule, *supra,* at p. A-7; Thieman, *supra,* at p. 372.) If a tax credit is in excess of the taxpayer's total tax liability for the given year, refundable tax credits permit individual taxpayers to receive a tax refund representing the difference. Non-refundable tax credits do not permit such refunds. In addition to the credit given for excess tax paid (see IRC § 6401) that is based upon simple bookkeeping principles, some tax credits take the form of policy incentives, such as the foreign tax credit (IRC § 27); the credit for qualified electric vehicles (IRC § 30); the low income housing credit (IRC § 42); the investment credit (IRC § 46); and the rehabilitation credit (IRC § 47(a)).

There is nothing in the statutory language of Revenue and Taxation Code section 17024.5, subdivision (b)(10) indicating that a "tax credit" resulting from overpayment of taxes should be treated differently than a tax credit intended to implement a specific tax policy. We cannot presume from its silence that the Legislature intended to exclude only one form of tax credit. (See *County of Los Angeles v. Superior Court* (2005) 127 Cal.App.4th 1263, 1269 [if Legislature intended particular construction of statute, it would expressly state its intent].)

### C. The State Board of Equalization Decisions Demonstrate that Only the Claim of Right Deduction Was the FTB Practice.

Case law supports the conclusion that California law did not incorporate IRC section 1341, and that prior to 1983 the common law claim of right doctrine was the practice in California. (See, e.g., *Appeal of Cuthbertson* (March 8, 1966) Cal. Tax Rptr. (CCH) ¶ 203-261 [1962-1966, Part 1 Transfer Binder] at p. 12,940 [taxpayer who must return income in subsequent years entitled to deduction in year of repayment]; *Appeal of White* (May 19, 1981) Cal. Tax Rptr. (CCH) ¶ 206-617 [1978-1981 Transfer Binder] at p. 15,033 [same].)

In *Appeal of Vertullo, supra,* California Tax Reporter (CCH) ¶ 205-505 [1971-1978 Transfer Binder], the taxpayers were required to return income for tax years 1970 and 1971. (*Id.* at p. 14,893.) Taxpayers were able to apply IRC section 1341 to avoid adverse federal tax consequences, and requested the same treatment from the state. (*Id.* at p. 14,893-2.) The state refused, stating that "[a]lthough a substantial portion of California tax law is based upon its federal counterpart, the Revenue and Taxation Code contains no provisions comparable to section 1341 or section 172. Thus, we view appellant's argument as a plea to this board to apply federal tax law to a set of circumstances with respect to which the California legislature has chosen not to follow the federal statutes." (*Ibid.*)

In *Appeal of Lovering, supra,* California Tax Reporter (CCH) ¶ 203-271 [1962-1966, Part I Transfer Binder], the taxpayers sought to amend their 1962 tax return to reflect income the husband returned to the federal government in 1962 because of his discharge from the Army. (*Id.* at p. 12,954.) The federal government gave the taxpayer a refund on his 1964 taxes on account of the repayment. (*Ibid.*) The taxpayer sought to claim a deduction for the returned income on his 1964 state tax return, conceding there was no counterpart to IRC section 1341 in California. (*Id.* at p. 12,955) The FTB disallowed the deduction because "there is no section in the California statutes which correspond to the Internal Revenue code of 1954, under which the federal authorities granted a refund to [taxpayer]." (*Id.* at p. 12,955.)

In *Appeal of Parker* (February 26, 1969) California Tax Reporter (CCH) ¶ 204-030 [1966-1971, Part 2 Transfer Binder], the taxpayers sought to recompute capital gains on a corporate dissolution in 1964 on their 1966 tax returns because they paid deficiency assessments related to those gains in 1966. (*Id.* at pp. 13,588-13,589.) The FTB rejected their argument, finding that prior to the enactment of IRC section 1341, if the transferee of assets of a liquidated corporation was required to pay a tax deficiency in a later year, the payment constituted a capital loss in the year of repayment. "Since section 1341 of the Internal Revenue Code of 1954 has no counterpart in California law, we must be governed" by cases decided before the enactment of IRC section 1341. (*Id.* at pp. 13,589-13,590.)[2]

**D. The Enactment of Revenue and Taxation Code Section 17049 Supports The Conclusion that IRC Section 1341 Was Not Incorporated.**

In 2004, the Legislature passed into law Assembly Bill No. 3073, which enacted Revenue and Taxation Code section 17049. Section 17049 expressly incorporated IRC section 1341 into California law. The Legislative history of A.B. No. 3073 indicates its passage was intended, with respect to Revenue and Taxation Code section 17049, to "conform" California law to federal law. (See, e.g., Assem. Rev. & Tax. Comm., Concurrence in Senate Amendments of Assem. Bill No. 3073 (2003-2004 Reg. Sess.) as amended July 12, 2004.) "This Bill would conform California's law with the federal practice of administering the claim of right doctrine, thus allowing a taxpayer who repays an amount of income received in the prior year to claim either an unrestricted deduction (rather than a 'miscellaneous deduction') or a refundable credit for the amount of tax paid in the prior year on the repaid income." (Sen. Rev. & Tax. Comm., Report on Assem. Bill No. 3073 (2003-2004 Reg. Sess.) as amended June 15, 2004; see also Sen. Rules Comm., Analysis

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[2] The only post-1983 case on the issue, *In re Appeal of Agnew, supra,* California Tax Reporter (CCH) ¶ 401-722 [1986-1990 Transfer Binder], demonstrates the practice continued post-conformity legislation. In *Agnew,* the taxpayers attempted to deduct moneys received as bribes that the taxpayers were required to turn over to the state of Maryland as part of a settlement. (*Id.* at p. 25,494.) The taxpayers argued the claim of right doctrine applied and permitted them to deduct from current income the returned monies previously declared and taxed as income in Maryland. (*Id.* at p. 25,495.) In denying the deduction, the FTB stated that "[t]he claim of right doctrine has in fact been applied in California personal income tax law but only when the repaid funds had previously been included in *California* taxable income. . . . However, it would hardly be 'equitable' for the taxpayers of California essentially to foot the bill for part of appellant's liability to the taxpayers of Maryland for bribes received while he was a resident and elected official of that state." (*Id.* at p. 25,495.) The case neither discussed nor considered the applicability of the other half of IRC Section 1341, namely, the tax credit/ refund of IRC section 1341, subdivision (a)(5).

of Assem. Bill No. 3073 (2003-2004 Reg. Sess.) as amended July 12, 2004.) The legislative history of Revenue and Taxation Code section 17049 demonstrates that IRC section 1341 had not been incorporated into California law prior to 2004. "The Legislature 'is deemed to be aware of statutes and judicial decisions already in existence, and to have enacted or amended a statute in light thereof.'" (*People v. McGuire* (1993) 14 Cal.App.4th 687, 694.) Given the case law and other precedent concerning California's tax treatment of returned income, namely, that the taxpayer was entitled only to a deduction, and the expressed intent to "conform" California law to federal law, Revenue and Taxation Code 17049 demonstrates that IRC section 1341 was not incorporated into California law prior to its enactment.

We cannot apply section 17049 to this action because statutes are not applied retroactively in the absence of express language directing retroactive application. (*Myers v. Phillip Morris Companies, Inc.* (2002) 28 Cal.4th 828, 840.) A statute has retrospective effect when it substantially changes the legal consequences of past events. (*Kizer v. Hanna* (1989) 48 Cal.3d 1, 7.) Furthermore, a statute does not operate retrospectively simply because its application depends on facts or conditions existing before its enactment. (*Ibid.*)

## III. PRIVILEGES AND IMMUNITIES CLAUSE.

Ackerman argues that the effect of denying him a tax refund of the overpayment of taxes for those years where he returned the income to its source results in a violation of the Privileges and Immunities Clause. (U.S. Const. Art. IV, § 2.) He contends that if he had been a resident of California for the tax years 1992 and 1993, he would have been able to use a deduction to offset California income earned during those years. However, because he was not a California resident during those years, he was denied effective tax relief because his California income was minimal in comparison to the taxes resulting from the 1986 to 1989 income. As a practical effect of the application of the California claim of right deduction rule, Ackerman contends he was subjected to unlawful discrimination solely because he was a resident of another state. The FTB contends that the claim of right doctrine was a non-discriminatory scheme that limited relief to a deduction in the year of repayment regardless of the taxpayer's location, and argues that the fact Ackerman was unable to recover taxes paid on his 1992 and 1993 income was an "unfortunate but accidental result due to the particular circumstances" unique to him.

The Privileges and Immunities Clause provides that "The Citizens of each State shall be entitled to all of the Privileges and Immunities of Citizens in the several States." (U.S. Const. Art. IV, § 2.) The Privileges and Immunities Clause is designed to "'strongly . . . constitute the citizens of the United States [as] one people,' by 'plac[ing] the citizens of each State upon the same footing with citizens of other States, so far as the advantages resulting from citizenship in those States are concerned.'" (*Lunding v. New York Tax Appeals Tribunal* (1998) 522 U. S. 287, 296 (*Lunding*), quoting *Paul v. Virginia* (1868) 75 U.S. (Wall.) 168, 180.) Thus, although residents of one state may be required to pay taxes in another state, the Privileges and Immunities Clause secures the rights of citizens of one state to "remove to and carry on business in another without being subject in property or person to taxes more onerous" in effect than those imposed under like circumstances than the citizens of the latter state. (*Shaffer v. Carter* (1920) 252 U.S. 37, 56 (*Shaffer*).) However, the Privileges and Immunities Clause "affords no assurance of precise equality in taxation between residents and nonresidents of a particular State. Some differences may be inherent in any taxing scheme" because the Privileges and Immunities Clause is not an absolute. (*Lunding, supra,* at p. 297.)

Courts apply the "substantial reason" test in determining whether discrimination against non-residents is prohibited by the Privileges and Immunities Clause. A state may defend its tax law that distinguishes between residents and nonresidents by showing (1) there is a substantial reason for the difference in treatment, and (2) the discrimination against nonresidents bears a substantial relationship to the state's objective. (*Lunding, supra,* 522 U.S. at p. 298.) The Privileges and Immunities clause "does not preclude disparity of treatment in the many situations where there are perfectly valid independent reasons for it. Thus the inquiry in each case must be concerned with whether such reasons do exist and whether the degree of discrimination bears a close relation to them. The inquiry must also, of course, be conducted with due regard for the principle that the States should have considerable leeway in analyzing local evils and in prescribing appropriate cures." (*Toomer v. Witsell* (1948) 334 U.S. 385, 396.) Ultimately, whether a state tax law contravenes the Privileges and Immunities Clause "must depend not upon any mere question of form, construction, or definition, but upon the practical operation and effect of the tax imposed." (*Shaffer, supra,* at p. 55.)

Before applying the "substantial reason" test, however, a court must find that there is discrimination. Here, the operation of California's deduction-only rule to recompense a taxpayer for returned income does not discriminate between residents and nonresidents. The rule had the practical effect of imposing on Ackerman a tax burden more onerous than that which would have obtained if he had remained a resident of California and had continued to earn substantial income. Nonetheless, there is nothing in the operation of the rule that intrinsically favors resident taxpayers; a resident taxpayer could face the same result if his income was minimal in a year that a substantial amount of a prior year's income was returned. Thus, with respect to the analysis under the Privileges and Immunities Clause, we need not consider whether the state can advance a substantial justification because there is no discriminatory treatment. Cases analyzing the reasons for discrimination demonstrate that this case does not present the issue appellant presses.

In *Travis v. Yale & Towne Mfg. Co.* (1920) 252 U.S. 60 (*Travis*), the Supreme Court found unconstitutional a New York income tax that that denied nonresident taxpayers a personal exemption granted resident taxpayers. (*Id.* at p. 79.) The court found the law made a substantial difference to out of state taxpayers and was without any justification. (*Id.* at pp. 80-81.) "This is not a case of occasional or accidental inequality due to circumstances personal to the taxpayer, [citations], but a general rule, operating to the disadvantage of all nonresidents including those who are citizens of the neighboring states, and favoring all residents including those who are citizens of the taxing state." (*Ibid.*)

At the same time, *Travis* upheld a New York tax law that limited the deductions of non-residents to those incurred in connection with the production of income in the state. (*Id.* at pp. 75-76.) In *Shaffer, supra,* 252 U.S. 37, decided the same day as *Travis,* the court reiterated this principle and explained, "[t]he difference, however, is only such as arises naturally from the extent of the jurisdiction of the state in the two classes of cases, and cannot be regarded as an unfriendly or unreasonable discrimination. . . . As to nonresidents, the jurisdiction extends only to their property owned within the state and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources. Hence there is no obligation to accord them a deduction by reason of losses elsewhere incurred." (*Id.* at p. 57)

Recently, in *Lunding, supra,* 522 U. S. 287, at issue was whether New York could effectively deny non-residents an income tax deduction for alimony paid. (*Id.* at pp. 290-291.) New York applied a formula that had as its numerator New York source income that did not include any deduction for alimony paid, and a denominator consisting of federal adjusted gross income, which figure included a deduction for alimony. This figure was applied to the nonresident's tax liability "as if" the taxpayer was a resident of New York. (*Id.* at pp. 291-292.)

There was no upper limit on the apportionment percentage, which could result in circumstances where a nonresident's New York income exceeded federal adjusted gross income, and the resident would be liable for more than 100 percent of the "as if" state resident tax. (*Id.* at p. 292.)

Prior to the 1987 enactment of the law applying the apportionment percentage, nonresidents were permitted to claim a pro rata deduction for alimony expenses. (*Lunding, supra,* 522 U.S. at p. 292.) This rule reflected a policy decision that nonresidents be permitted the same non-business deductions as residents, but only in the proportion of the New York income to income from all sources. (*Ibid.*; see *Friedsam v. State Tax Comm'n* (1984) 64 N.Y.2d 76, 81.) There was no legislative history explaining the rationale for the new rule, and the appellate division of the trial court found the rule violated the Privileges and Immunities Clause because there was no substantial reason for the discrimination beyond the fact the nonresidents were citizens of other states. (*Lunding, supra,* at pp. 293-294.) On review, the Court of Appeals reversed, upholding the rule, and finding that limiting taxation of non-residents to their in-State income provided the rationale for limiting their deductions to in-state sources. (*Id.* at p. 294.) Furthermore, the court found New York residents were subject to the burden of taxation of all of their income regardless of source and therefore should be entitled to the benefit of full deduction; and where deductions represent personal expenses of a nonresident taxpayer, they are more appropriately allocated to the state of residence. (*Id.* at p. 295.)

The Supreme Court rejected arguments that the state's inability to tax a nonresident's entire income justified the discrimination, and pointed out that *Shaffer* and *Travis* did not automatically condone any denial of deduction on the assumption that such amounts were allocable to the state in which the taxpayer resided. "Alimony obligations are unlike other expenses that can be related to activities conducted in a particular state or property held there." A scheme more consistent with notions of fairness would allow nonresidents a pro rata deduction for alimony paid. (*Lunding, supra,* at pp. 314-315.) The Supreme Court concluded that because of the absence of any reason for the differential treatment of nonresident taxpayers, the New York tax law violated the Privileges and Immunities Clause. (*Id.* at p. 315.)

In *Davis v. Franchise Tax Board* (1977) 71 Cal.App.3d 998, the court considered a challenge to California's income averaging under the Privileges and Immunities clause. Income averaging was an elective method of computing income tax by which an individual who has large income in one year as compared with other years to have the excess taxed at lower rates applying to the average of five years of income. Revenue and Taxation Code section 18243 limited income averaging to taxpayers who were California residents during a five-year period. (*Id.* at p. 1001.) The provisions were modeled after federal income averaging rules, which denied income averaging to any taxpayer who was a nonresident alien at any time during the five year period. (*Id.* at p. 1001; see IRC § 1303, subd. (a) and (b).) The taxpayers challenging the California statute had been California residents for the years 1969 to 1972, and sought to include 1973 in their income averaging. (*Id.* at pp. 1000-1001.)

*Davis* reasoned that the purpose of California's income averaging rule was to bring taxpayers with widely fluctuating income into a position of approximate parity with those of relatively stable income. (*Davis v. Franchise Tax Board, supra,*. at p. 1002.) Furthermore, California income taxes were limited to income from sources within California, and ignored a nonresident's out-of-state income in fixing the nonresident's tax bracket, giving the nonresident the benefit of a tax bracket that may not be based upon his ability to pay. (*Ibid.*) If income averaging were available to nonresidents, however, "the nonresident could display a fluctuating California income as a cloak for nonfluctuating total income," thus providing a nonresident with an option not available to residents. Therefore, "[i]nstead of forcing the nonresident to show out-of-state income as a condition of income averaging, California has chosen to deny [the taxpayer] the option." (*Id.* at p. 1003.) Although the taxpayers in *Davis* were in an "idiosyncratic position," they could not take advantage of California's income averaging rule. (*Id.* at p. 1004.)

## IV. THE CLAIM OF RIGHT DOCTRINE MAY NOT BE CONSTRUED TO ACHIEVE A RESULT BEYOND THE SCOPE OF THAT DOCTRINE.

Ackerman argues that the common law claim of right doctrine derived from *North American Oil* has no bearing on whether a state must restrict a taxpayer to the deduction in year of repayment remedy. In this instance, he argues, simple equity calls for construction of the doctrine to permit a refund; otherwise, the state will receive an inequitable windfall. Because *North American Oil* was founded on considerations of equity, Ackerman contends that it also should mandate a refund in this instance.

Essentially, Ackerman seeks equitable relief to avoid a forfeiture. (See, *People v. Far West Ins. Co.* (2001) 93 Cal.App.4th 791, 795 ["[f]ollowing the Anglo-American legal maxim that 'equity abhors a forfeiture,' the law 'traditionally disfavors forfeitures. . . .'"].) However, we cannot rely on the claim of right doctrine to achieve the equitable result requested by Ackerman because that doctrine is limited to the deduction in year of repayment.

## DISPOSITION

The judgment of the superior court is affirmed. The parties are to bear their own costs on appeal.

NOT TO BE PUBLISHED IN THE OFFICIAL REPORTS

ZELON, J.

We concur:

PERLUSS, P. J.

JOHNSON, J.